Council of Petroleum Accountants Societies

Turning Energy Into Synergy

May 4, 2017

Luis Aguilar
Regulatory Specialist
Office of Natural Resources Revenue
Building 53, Entrance E-20
Denver Federal Center
West 6th Ave. and Kipling St.
Denver, Colorado 80225

Comments on the Advance Notice of Proposed Rulemaking - Proposed Rule on the Consolidated Federal Oil and Gas and Federal and Indian Coal Valuation Report (1012-AA21)

COPAS is a professional organization comprised of the oil and gas industry's most knowledgeable and influential accounting professionals. COPAS has operated as a non-profit entity for 50 years and has over 4,000 members with 24 societies in the United States and Canada. COPAS was established in 1961 by representatives from various independent local societies throughout the U.S. and Western Canada. These societies recognized the need for standardized procedures and guidelines as the oil and gas industry expanded across the country so that common issues and problems could be addressed in a central forum. The societies have developed standardized documents in areas such as joint interest accounting, auditing, production volume and revenue accounting, and financial reporting and tax matters so that companies operating in all parts of the U.S. and Canada can effectively and efficiently use the same standards and guidelines. Additionally, many of our members are responsible for the filing of the Federal royalty reports to the ONRR.

COPAS appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking concerning the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Rule. With that said, we would like to provide comments for the following areas:

1. COPAS agrees with ONRR that gross proceeds from arm’s-length contracts are the best indication of market value, and we support ONRR’s efforts to collect every dollar due, adding reporting requirements only when cost justified.
2. We support ONRR developing an “Index Option” which would simplify and provide certainty in the reporting of Federal royalties. We believe the details of ONRR’s index option in the 2017 Federal Oil & Gas Valuation Rule had significant flaws that need to be corrected before it can be viable to our members.
3. COPAS supports regulations that are clear, consistent, and provide certainty.

4. COPAS does not support duplicative and administratively burdensome reporting requirements, requirements that are difficult if not impossible to comply with.
5. COPAS does not support valuation changes that do not allow gross proceeds from arms-length contracts or result in ONRR collecting more royalties than what is due.
6. COPAS suggests ONRR consider bringing back the Royalty In-Kind Program. If they do, it needs to have a better way of handling imbalances, and there needs to be clear, consistent and appropriate regulations in advance of implementation.
7. COPAS has not, and never will support retroactive valuation or reporting changes.

Default Provision

COPAS believes the 2017 final valuation rule provided too much discretion resulting in additional uncertainty, with some situations being inappropriate for the ONRR to invoke the "Default Provision".

First, COPAS recommends keeping the current benchmark system and expanding it to apply to situations where the lessee is unable to provide a copy of an arms-length contract.

If ONRR proceeds with a "Default Provision" we strongly recommend amending the 2017 Federal Oil & Gas Valuation regulations in the following areas:

- ONRR needs to identify who has the authority to invoke the "Default Provision." Is it Audit & Compliance Management, the Asset Valuation Team, the Office of Enforcement, Delegated states, and/or anyone else?
- Anytime ONRR invokes the "Default Provision", the remitter needs to be notified of the reason/justification as to why it is being invoked, so the remitter could provide additional information or justification as to why it should not be. Additionally, the notice should be sent to the individual/s identified on the ONRR Form 4444 that handles Audit & Compliance correspondence. In ONRR's notice should also include the lessee's rights to appeal.
- The "Default Provision" should not be invoked for simple or inadvertent reporting errors.
- ONRR should not be able to invoke the "Default Provision" because the value is 10% below the lowest reasonable measure of value in arms-length situations. Current regulations require the value to be reasonable, so adding an arbitrary "10% below the lowest reasonable measure" requirement is unnecessary and should not be included in the next valuation rule.
- Similarly, ONRR should not be able to invoke the "Default Provision" because the transportation or processing allowance is 10% above the highest reasonable measure of transportation or processing. Current regulations require deductions to be reasonable actual costs, so it is unnecessary and should not be included in the next valuation rule.

Transportation Deductions

COPAS believes the 2017 Federal oil & gas valuation rule eliminated several transportation deductions that should be allowed and/or retained in next proposed Federal valuation rule:

- The transportation allowance for OCS leases for the movement to first platform should be codified into the next valuation rule. MMS previously determined after a significant amount of research and comments that the current regulations allowed these transportation allowances. In discussions with industry prior to the May 20, 1999 guidance letter on "Determining Transportation Allowances for Production from Leases in Water Depths Greater Than 200 Meters" it was recognized that utilization of subsea completions tied to host platforms was key in the ability to develop leases in water depths greater than 200 meters. It also noted this allowed smaller fields to be developed economically that would not have been if the construction of a platform was required. It was also recognized that the products would be transported/severed off the lease in a commingled stream and then separated on the host platform. ONRR recognized the transportation as an allowed deduction for royalty bearing products. ONRR stated that they felt the current regulations allowed for the transportation allowance and requested industry agree to the use of a guidance letter for industry and ONRR to use instead of going through the process of revising regulations to clarify the application of the subsea producer owned transportation allowance. In all discussions ONRR recognized the cost of this transportation as being an allowed deduction that is supported by the regulations. The next oil & gas valuation rule needs to include these as allowed transportation costs or at least grandfather in the existing transportation systems.

- The ability to request approval to exceed the 50% limit on transportation allowances needs to be retained in the next proposed Federal valuation rule for both oil, gas and plant products. There are operational/environmental/current pricing circumstances that result in the regulations appropriately allowing exceptions to exceed the 50% transportation cap. As required by the current regulations, all exceptions must be requested and the transportation costs must be <u>actual, reasonable and necessary</u>. ONRR can deny any request that does not meet these standards. If ONRR wants to reduce the administrative costs for processing these requests for exception, they should consider approving the exception for periods of 2 or more years versus requiring they be approved every year.
- As stated in previous comments, COPAS does not support the elimination of netting a "transportation factor". Having to review all sales to determine if there are any transportation factors is administratively burdensome and may require expensive software changes. We support MMS/ONRR's position that was identified in the 1988 Final Oil & Gas Valuation Regulations which stated: "The MMS has determined that the regulations should be revised to provide that transportation factors which reduce arm's-length sales contract or posted prices are to be considered as reductions in value rather than transportation allowances."
- COPAS also wants to point out the "transportation factor" was not defined in the 2017 valuation rule, and it is unclear what is or is not a 'transportation factor." If ONRR pursues not allowing the netting of the transportation factor, it needs to be clearly defined (eg. NGL transportation and/or fractionation, purchaser incurred transportation on oil and/or gas).
- If ONRR determines the "transportation factors" are to be included in the transportation allowance, then the regulations also need to be expanded to include the "transportation factors" as an allowable transportation cost. Additionally, the final regulations need to acknowledge that some factors are not <u>incurred</u> by the lessee, as they are simply netted by the purchaser from their payment.
- In the 2017 Federal Oil & Gas Valuation Rule under the transportation allowance Section 1206.153(c)(8) - *Other non-allowable costs,* it required the lessee to place the gas, residue gas or gas plant products into marketable condition at no costs to the lessor as identified under Section 1206.146 (marketable condition rule) <u>and</u> it disallows the costs of boosting residue gas as identified in 30 CFR 1202.151(b). COPAS believes the addition of this language is inconsistent with the full reading of 30 CFR Section 1202.151(b) which explicitly allows exceptions for the deduction of boosting residue gas or other expenses incidental to marketing. 30 CFR 1202.151(b) says "no allowance shall be made for boosting residue gas or other expenses incidental to marketing, except as provided in 30 CFR part 1206. If ONRR wants to propose the additional language disallowing the

boosting of the residue gas, then it needs to also add language saying the lessee must place the gas, residue gas or gas plant products into marketable condition "only once" at no costs to the lessor. The "only once" language needs to be added throughout the next prosed rule anywhere it says the lessee must place the gas, residue gas, gas plant products into marketable condition. As proven numerous times, most recently at PASO, ONRR is incorrectly requiring companies to place the gas into marketable condition twice or more, resulting in the disallowance of actual transportation and/or processing costs.

Non-Arms-Length Transportation

- The multiplier of 1.3 times the S&P BBB Bond rate should also be retained. A lot of analysis was done by the MMS justifying the 1.3 multiplier when it was added to the regulations. At the time, MMS stated: "MMS, through its Offshore Minerals Management, Economics Division, has studied several years' worth of data for both non-integrated oil transportation companies and larger oil producers, both integrated and independent, that MMS believes are more likely to invest in oil pipelines. After a thorough review of the MMS and API studies, and consideration of the comments submitted by States and industry, we believe that the allowance for the rate of return on capital should be adjusted to 1.3 times the Standard & Poor's BBB bond rate. This number is the mid-point of the range suggested by the MMS study, which concluded that the range of rates of return appropriate for oil pipelines would be in the range of 1.1 to 1.5 times the Standard & Poor's BBB bond rate." In 2005 when the multiplier was added to gas transportation, the MMS said: The MMS believes that the study conducted by its Economics Division, Offshore Minerals Management, used the most relevant data for a reasonable period and, therefore, is the best source to decide on the appropriate rate of return. If ONRR believes the 1.3 multiplier is no longer correct, they should perform a current study to determine if it should be eliminated, retained or increased. COPAS also recommends ONRR do a comparable study to determine if a multiplier should be added for non-arms-length processing costs.
- ONRR should retain the ability for the lessee to request an exception to having to compute actual transportation costs. COPAS believes the current use of FERC/State approved tariffs provides certainty to both industry and the ONRR, represents fair and reasonable transportation charges, and eliminates any duplication of effort between ONRR, the FERC and State agencies.

Processing Deductions

- The ability to request approval to exceed the 66.67% processing cap needs to be retained in the next proposed Federal valuation rule. As previously documented, there are extenuating circumstances where unique production profiles with little or no liquids to offset all the processing costs or other operational/environmental/current pricing circumstances (eg. keepwhole contracts) that result in exceeding the 66.67% processing cap. The lessee on a case-by-case basis, must submit a request to exceed the 66.67%, and the transportation costs must be actual, reasonable and necessary. ONRR can deny any request that does not meet these standards. If ONRR wants to reduce the administrative costs for processing these requests, they should consider approving the exception for periods of 2 or more years versus requiring they be approved every year.
- The next proposed Federal valuation rule needs to retain the ability to request or at least grandfather in the existing extraordinary processing allowances. As supported by the two fields with extraordinary allowances, there are fields that have unique gas composition,

complex plant designs and extremely high unit costs with significant investments that justify them being extraordinary.

- All compression and other costs integral to the plant processing function need to continue to be allowed processing deductions.

Gas Index Pricing Option

COPAS supports the option to choose index pricing for unprocessed and processed gas, and strongly recommends the option be available to arms-length sales (this was recommended by the 1995/96 Federal Gas Valuation Negotiated Rulemaking Committee) as they too, have the same tracing and unbundling issues as those lessees with non-arms-length sales. To simplify reporting, COPAS would also support an approach similar to the 2000 Indian Gas Valuation Rule which provides a bump in value based upon the lease's btu content, and the lessee's ownership in the processing plant.

Unfortunately, the index pricing terms enumerated in the 2017 Federal valuation rule resulted in a value so far above what is reasonable, that it was doubtful many lessees will have chosen it. More specifically we point out the following areas that would need to be adjusted for the next proposed Federal valuation rule:

- Instead of the highest reported monthly bid week price, it should be on the average price.
- The index price should be based upon which way (which pipeline or index) the lessee's gas flowed. The 2017 Federal gas valuation rule does not appropriately account for pipeline constraints or the lessee's inability to obtain access to all markets.

Index Pricing Option for Gas (Transportation Deduction)

The transportation deductions and the floor and cap need to be increased to reflect the current market.

- The 10% of the gas index for all other areas was derived from the Indian Gas Valuation Rule based upon transportation deductions associated with periods prior to 2000 and is not reflective of the transportation rates we are seeing today.
- The 5% of the gas index for OCS GOM needs to be higher and not lower than onshore, as offshore transportation does not have the unbundling issues associated with onshore. Additionally, the OCS GOM has the IBLA 97-120 approved TLP transportation and the subsea transportation allowances, and much higher capital costs making it more expensive than onshore. There should also be a differentiation between deep and shallow waters.
- The floor and ceiling for transportation deductions (can never be below \$0.10 per mmbtu nor above \$0.30/mmbtu) was based upon the 15 year-old Indian Gas Valuation rule and is not reflective of current transportation costs. Both the floor and ceiling needs to be raised to be more reflective of the current market.

Index Pricing Option for NGLs

COPAS supports the option to choose index pricing NGLs, and strongly recommends the option be available to arms-length sales as they too, have the same tracing and unbundling issues as those lessees with non-arms-length sales. Unfortunately, the terms in the 2017 Federal valuation rule identifying the index price you must use was unclear, and the allowed deductions were not reflective of the current market and do not cover all the transportation costs incurred by the lessee.

- The 2017 Final rule stipulated that you must reduce this price by the amount ONRR posts on their website:

    - Theoretical processing allowance (Onshore - $0.15/gal; GOM - $0.10/gal); and
    - T&F charge (NM - $0.07/gal; Other Onshore - $0.12/gal; GOM - $0.05/gal). Appears low.
- These standard processing deductions were based on the minimum monthly rate over a 5-year period. This is too long for which the minimum monthly rate should be chosen. To be more market sensitive, the chosen rate should be over the most recent year or two. There is concern with using ONRR 2014 information as some companies are not deducting anything or have already started unbundling, therefore, choosing the minimum monthly rate may not be appropriate.
- The 2017 rule also said the reductions would be updated periodically, but ONRR needs to update them annually, and they should be prospective only.
- The standard deduction for T & F charges only represents costs after the processing plant and does not include a transportation allowance to get the NGLs to the plant. The 2017 rule allows a theoretical transportation allowance for field transportation for unprocessed and processed gas, but does not provide a similar standard deduction for the NGLs. A standard deduction for the transportation of the ngls from the lease to the plant needs to be provided in the next proposed Federal valuation rule.
- The standard T&F charges in the 2017 rule are too low/old and out of sync with the current rates for transportation and fractionation.

Miscellaneous Comments

The current regulations require accounting for comparison, and COPAS recommends this requirement be eliminated, as it requires too much effort and manpower for very little additional money.

The current regulations also require keepwhole accounting/reporting as processed gas. Because the information to perform the keepwhole accounting are not available in most cases, this requirement should be eliminated particularly in arms-length situations. If keepwhole accounting is retained in the next proposed Federal valuation rule, the requirement needs to be simplified by allowing the use of the index pricing for ngls if the lessee does not have any ngl sales for that lease or area.

COPAS believes where gas sales already exist, the same gross proceeds net of allowable transportation should be used to value field fuel, lost & unaccounted for volumes, and any royalty bearing vented and flared volumes. COPAS believes this value best represents what the gas could have been sold for.

Other Opportunities to Further Streamline Valuation Process:

If ONRR does not provide for the lessee to value their royalties using an index option in arms-length situations, to minimize the burden and effort of unbundling third party contracts, ONRR should investigate developing and providing standardized rates for compression, dehydration, and/or treating. The lessee could then determine the disallowed services needed to place the gas, residue gas, and gas plant products into marketable condition, and add back the ONRR determined standardized rate for each service. Because of the complexities involved, we would be interested in meeting and discussing how the calculations/schedules would work, the need for them to be updated periodically, and for them to be an option to allow lessees to use actual costs. These standardized rates would eliminate the need for unbundling and prior period adjustments.

Another opportunity involves how non-arm's length transactions are treated for determining royalties. COPAS recommends ONRR allow a company to use the previous year's actual costs/rates for the current year provided they are within a threshold, and not have to do prior period adjustments in the following year when the actual information is available. An additional option would be to take the below threshold adjustment for which no adjustment was made, and to roll it forward into the deduction for the following year.

If in the next proposed Federal valuation rule, ONRR was to include an index pricing option, COPAS also recommends the lessee be allowed the option to deduct the standardized processing or transportation deductions ONRR is going to post for the index pricing option. Thus, the lessee could still use their arms-length product price, but they could deduct the standardized processing or transportation charge.

Closing Comments

COPAS wants to emphasize that due to the magnitude of the valuation, accounting, and ONRR 2014 reporting changes associated with any new proposed Federal valuation rule, at least 12 months will be needed from when the final rule and any 2014 report reporting changes are published to make all the accounting and system changes.

Once again, COPAS appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking. COPAS also welcomes and encourages additional opportunities for Industry participation in drafting these valuation rules. We believe industry can provide valuable insight to ONRR on how the proposed valuation rules will impact royalty reporting and payments. If you have any questions regarding our comments, please contact me at (918) 877- 0792.

Sincerely,

Trey Thee
COPAS Revenue Committee Chairperson